

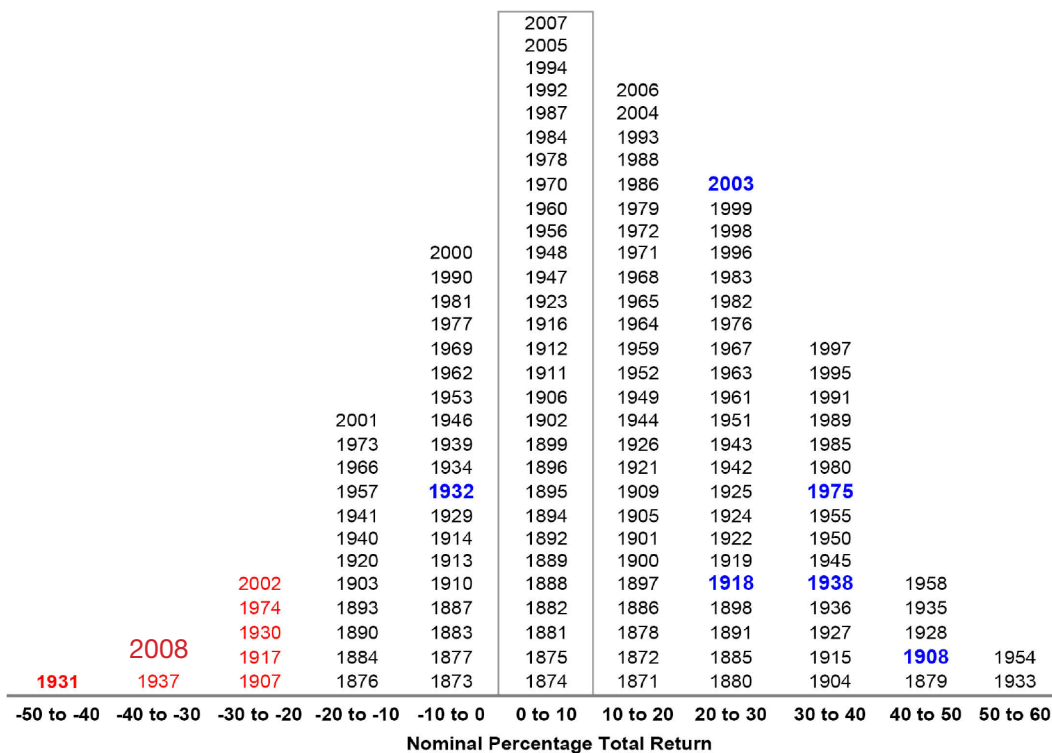


Investment Outlook & Review

January 2009

IN EARLY AUTUMN, THE EXPECTATION THAT A GLOBAL RECESSION IN 2009 WAS PROBABLE, IF NOT NECESSARILY CERTAIN, AFFECTED ALL INVESTORS IN BOTH EQUITY AND FIXED-INCOME MARKETS. ANY COMMODITY-RELATED OR CYCLICAL STOCK WAS SOLD HEAVILY AND MARKETS GENERALLY BEGAN TO PANIC AS INVESTORS BELIEVED THE AUTHORITIES WERE FAILING TO TAKE THE MEASURES NEEDED TO STABILISE THE FINANCIAL SITUATION.

THEN LEHMAN BROTHERS WAS ALLOWED TO FAIL AND THE LAW OF UNINTENDED CONSEQUENCES CAME INTO PLAY IN A SPECTACULAR MANNER.



Distribution of S&P 500 annual total returns since 1871. This chart illustrates how extreme 2008 was for stock markets - the second worst year in the US since 1871. The red figures mark the worst annual performances, the blue denote the subsequent year.

From late September through to the end of October, any small signs that policy changes previously implemented were beginning to make a difference, were blown away by unprecedented fund redemptions and forced liquidations (not only by hedge funds). This led to a self-feeding equity market crash.

A large part of the selling seemed totally irrational, far more so than during the 1987 Crash, with equities being dumped irrespective of valuations or corporate

fundamentals. Hedge funds, named and shamed by the media as the principal villains in the selling frenzy, were often forced sellers, but in practice were only one factor in an already dire situation.

The result has been that investor sentiment and any appetite for risk has been hit badly, and it will take some time to recover.

Whilst this storm was hitting all markets, and proving the last straw for some, it was easy to miss any positive news. Central bank intervention in financial markets has been much more proactive and better coordinated than in



previous financial crises. The US Treasury's bail-out plan (TARP) has been changed into a bank recapitalisation plan, which is probably what it should have been in the first place, like the much praised UK model where certain banks were part nationalised. Credit markets have also shown some signs of easing, although prices remain at historically low levels.

The financial crisis in recent months has been likened to an earthquake. One of the problems with earthquakes is the probability of aftershocks, and as more bad news is uncovered and announced, investors worldwide fear this could be the case in markets. Auditors will be studying the accounts of all financial companies with even more care than usual from the end of the year, especially given the recent suspected fraud of Bernard Madoff's hedge fund, which has affected investors worldwide. If there is any time to be ultra-conservative, this is it.

Markets generally could re-test their lows in the first few months of 2009 if the flow of corporate and financial news remains relentlessly negative. There is a whiff of 1974 about – when dealing in markets was compared to Chinese water torture, as a steady drip of bad news sent prices lower.

However, unless the aftershocks mentioned above are worse than expected (another major financial institution failing, for example) markets should shortly be able to concentrate on the global recession alone – and markets generally understand recessions. Analysts and investors know from experience which sectors and companies in any given market tend to outperform, who to question to discover how economies and companies are performing, and which indicators to watch for signs of a recovery.

We are not at this stage yet, though there are a few suggestions that perhaps sanity is tentatively returning to investors' perceptions in both the equity and bond markets. There is undoubtedly great value out there, but given further uncertainty about the economic outlook and further deleveraging, the current market is only suitable for those that can tolerate further short term volatility and have a long term investment horizon.

It is noticeable in the last few weeks that for the first time in nearly eighteen months, i.e. from the beginning of the credit crisis, sectors that traditionally outperform a falling market (high quality corporate bonds, higher yielding blue chip companies, etc) have started to do so, after many months of performing just as badly as their supposedly riskier counterparts. Liquidity is very slowly returning to the corporate bond market as investors realise the better risk/return qualities of this asset class (i.e. bond holders rank ahead of equity holders in a corporate structure) and valuations have reached prices that imply a default rate unseen since the 1930s.



The previous comments apply worldwide, although different regions will suffer the effects to a greater or lesser degree.

UK

As we highlighted in our last review, as well as decisive action by the Monetary Policy Committee, stimuli to get the credit markets moving were required. The quarter opened with a coordinated cut in interest rates by global central banks, and in the UK the Bank of England cut rates by 50 basis points to 4.5%, indicating the severity with which the authorities viewed the crisis and the levels to which they were now prepared to go. What was ultimately seen as a modest rate cut in the UK did little to improve sentiment on the stock market and on 10th October the FTSE suffered its biggest single day percentage fall of -8.8%. As the UK market reached its lowest level for more than five years, the US rescue package for Citigroup served to propel the FTSE to its single biggest one day percentage rise of 10% on 24th November, indicating the market's overwhelming desire for good news. Economic data and business surveys however continued to disappoint as evidence of a deepening recession emerged – manufacturing output grinding to a standstill, consumer confidence declining fast, devaluation of sterling, house prices in steep decline. Given that inflation fears had disappeared, the MPC was able to cut interest rates to 2%, and again on 8th January to an all-time low of 1.5%, in an effort to restore confidence in the financial system. The consequence to this policy was a dramatic fall for sterling against the US dollar and the Euro. At the time of writing, £1 only buys \$1.50 compared to \$1.80 at the start of the quarter and has fallen to €1.05 from €1.30.



Sterling's fall versus the US Dollar during 2008 (Source: Sharescope)

Against this severe picture and whilst we expect further downward revisions to economic forecasts going into 2009, the stock market, as a discounting mechanism, is now providing the shrewd and wary investor with many opportunities. We have no doubt that many more businesses will fail in the economic downturn but this will enable those companies with strong business models and solid balance sheets to emerge all the stronger. These are

likely to be those with bigger capitalisations, which, due to their international operations, will also benefit from the weaker pound.

The FTSE All Share Index looks very attractive when comparing the dividend yield relative to the yield available from gilts. Even once dividends are stripped from the financials sector - historically a large proportion of the income, which will be disappearing given the recapitalisation of the banking sector, the dividend yield from the index is still greater than that from government bonds.

Asia ex Japan

Asian-ex Japan economies and markets are in a much better shape than during their last crisis in 1997. Short-term debt is lower and most countries are running a current account surplus. This was not enough though to shield local markets and currencies from the global panic as any liquid stock was sold down heavily. As a result Asian valuations have recently approached the lows last seen in 1997 (based on price-to-book and historic price/earning ratios) even though return on equity has doubled over the last decade. Due to the strength of corporate and government balance sheets, the region is arguably more attractive than Western markets.

However, China is the key to any improvement in sentiment. Growth forecasts, both from internal and external observers, have been downgraded to such an extent that there are fears of civil unrest as unemployment rises and the, until now, steadily-growing cake begins to shrink, or at least stays the same. The authorities are well aware of the risks and are making changes to alleviate any downturn and to counteract the growing dependency on exports and global trade. Interest rate cuts, a rise in bank-lending quotas and changes to tax levels are all designed to make any slowdown as painless as possible. Only time will tell whether these measures are effective, but as soon as there are any signs of recovery, or even stabilisation, investors generally in Asia will take heart and prices will begin to recover.

Japan

Japan is marching to a different tune. The stock market fell sharply, as elsewhere, in the autumn but has still relatively outperformed during the year for UK investors due to the strong yen. As has been the case for some time, valuations look very cheap, even after the strengthening of the yen, which will severely impact exporters' earnings, but international investors in particular seem to have little appetite for increasing positions. After more than ten years of disappointment it is difficult to see what will be the catalyst for a change in attitudes. Perhaps the relative outperformance of Japanese equities will attract buyers in the New Year and perhaps this will be another false dawn.



Continental Europe

Continental European markets suffered similarly to the rest of the world during October, with governments falling over each other in the rush to save financial institutions across the continent from failing. Several of the smaller, more peripheral markets saw dramatic falls and some emerging economies had to ask the IMF for help.

The main European economies are now certainly in recession. How severe this will be, and for how long, is too early to predict. Negative factors are that earnings forecasts are still too high and financial institutional problems may continue into the early part of the New Year; consumer confidence is at a 15 year low and trade unions often prove to be stumbling blocks for corporations when trying to restructure businesses. But as market volatility declines and economic fundamentals stabilise, many attractive opportunities are beginning to appear. The economy may seem to be one of the least attractive on a relative basis (after only the UK) but much of the bad news seems already discounted in stock market and bond prices.

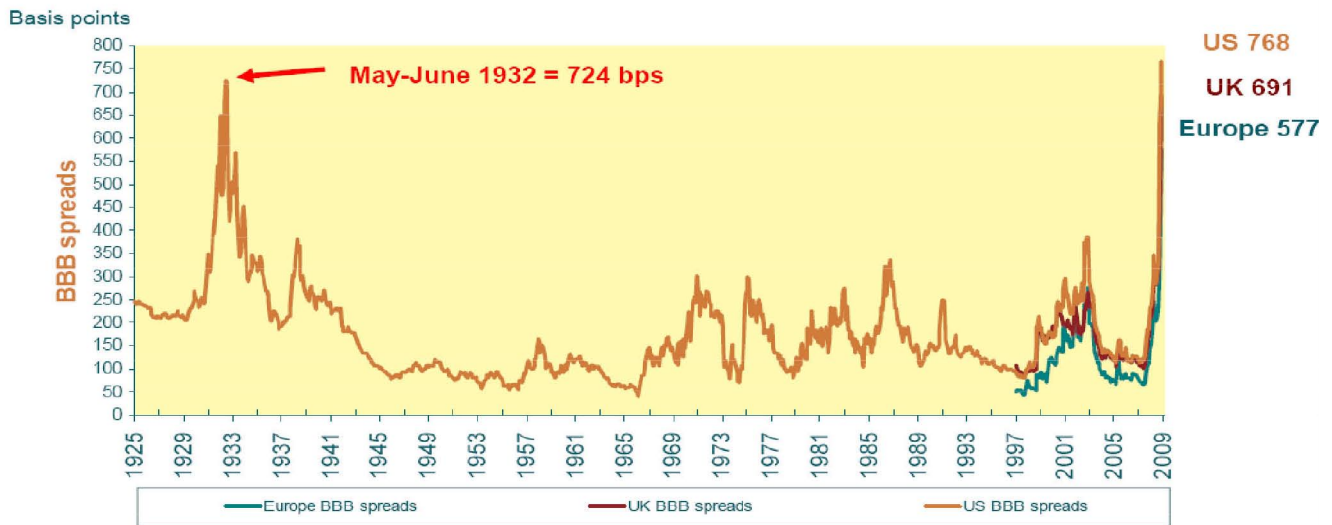
United States

The fear in the US has been deflation, with the possibility of a repeat of the Japanese experience in the last decade looming large in investors' concerns. The actions in recent months of the current US Treasury team have also not inspired confidence. US bond markets are still in 'deflation mode' with negative inflation being discounted for the next five years.

The problems and fears are being exacerbated by the transition period between presidents. Markets hate uncertainty and growing concerns that Obama's inauguration may be too late to tackle the deteriorating economy led him to take the unusual step of announcing his fiscal stimulus plan prior to being sworn in. The plan is predictably large and includes tax cuts, increased government spending and a promise to "create or save" millions of jobs. Response to his proposal has been mixed, however poor economic news has continued seemingly unabated.

Against this rather negative background there are several major positives. Firstly, the Federal Reserve is being run by someone who has spent his whole academic life studying the 1930s and who should know what measures need to be taken to prevent a recurrence of the disasters seen then (interest rates have been reduced to zero to combat deflation). Secondly, the American 'state' is a past master at solving problems quickly and imaginatively. Thirdly, the US tends to enter a recession first but also recover more quickly than elsewhere.

Following the pattern in other markets, on-paper valuations look very attractive again but these are based on future earnings forecasts that have still yet to be reviewed. This should happen in the coming few months and at that stage, assuming no other financial calamity similar to Lehmans occurs, the market will show outstanding value.



Bonds

Finally, corporate bond markets around the world look particularly cheap after the strong performance from government bonds during the crisis. Many bond managers are saying this is the “best buying opportunity for corporate bonds in a generation”.

The chart above (courtesy of M&G) illustrates this well. It shows the spread (the extra yield over government bonds – 100 basis points (bps) = 1%) of investment grade bonds since 1925. While it is certain that the global economy is going to experience a very tough couple of years, it is a bold statement to say that 50% of all companies will default on their bond coupon or principal over the next 5 years, which is what this chart implies.

Over the coming couple of years, investors can expect to receive not only a significantly higher income return than is available from bank deposits but also a positive capital return as spreads narrow. This will happen as soon as liquidity improves and investors realise that corporate bond pricing has become separated from reality. The government bond market, meanwhile, has been the best performing asset class in 2008. A combination of falling interest rates, deflation fears, good liquidity and

a safe haven from other volatile assets has resulted in the sector having one of its best years since 1997 (as measured by the performance of the IMA UK Gilt sector). In the short term, government bonds offer some protection against further setbacks in “risk assets”, but offer little value over the long term with yields at such low levels.

Summary

In summary, equity and bond markets look cheap, but with major caveats. Uncertainty abounds - the length and depth of the recession, the success of the central banks in combating deflation, the effect this will have on corporate earnings and investors’ appetite to resume investing in financial markets again are at the head of the list. We are conscious that 2008 was unprecedented and we don’t have history to guide us through this crisis, so we have to have faith that governments and central banks will provide the monetary stimulus to save us from a deep and prolonged recession, and we have to base our investment decisions on sound fundamentals. Therefore, given the value in many asset classes, over the coming months selective purchases of both bonds and equities worldwide are likely to prove very rewarding over the medium to long term.

Performance of major asset classes in 2008 in local currencies (Total Return)

Name of Index	Asset Class	Period performance %
FTSE 100	UK Shares	-28.33
MSCI AC World Index	Global Equities	-39.17
MSCI Euro	European Equities	-43.56
S&P 500	US Equities	-37.00
Nikkei 225	Japanese	-42.12
Hong Kong Hang Seng	Hong Kong	-48.27

Name of Index	Period Performance %
Credit Suisse Tremont Hedge Fund Index GTR	-19.04
FTSE British Government Bonds	+12.81
IPD UK Property	-18.22
Merrill Lynch Sterling Non Gilts (Investment Grade Corporate Bonds)	-3.62

Source: Financial Express



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